

ABC of Preferential Trade Agreements

Frequently Asked Questions



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Monographs on Globalisation and India – *Myths and Realities*, #14

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Preface

The impact of preferential trade agreements (PTAs) on the economic fortunes of both nations and individual stakeholders has become significant in recent times. In fact these have emerged as an alternative path to multilateralism for the progress of trade liberalisation. It would be fair to say that the fortunes of every stakeholder, whether producer, consumer or intermediary, are linked to the negotiation of such trade agreements.

But despite the extensive impact of these agreements, knowledge of processes, nuances and associated consequences is limited to only a privileged few. Even basic knowledge regarding underlying concepts is lacking. This monograph constitutes a step to remedy this state of affairs. The objective of this monograph is to provide non-technical explanation of technical concepts linked to these agreements. But this monograph is much more than a dictionary – it also helps the reader develop an appreciation of how PTAs have evolved, the related pros and concerns and the various schools of thought regarding their desirability and compatibility with multilateralism.

This monograph should make the ongoing discourse/debate on PTAs intelligible to a more varied and larger group of stakeholders and help them link their fortunes to the progress or lack of it in negotiations relating to preferential trade agreements. It is, therefore, hoped that this monograph and similar efforts would help enhance stakeholder's interest in PTA negotiations and thus result in these becoming more representative of stakeholder preferences.

Siddhartha Mitra
Head, CUTS Centre for International Trade,
Economics & Environment

Introduction

Multilateralism is the best option for promoting a more equitable and fair trading system. However, Preferential Trade Agreements (PTAs) have been increasing exponentially, as countries seek to gain market access and seize opportunities offered by preferential deals due to the slow progress at the multilateral level. About 50 percent of world trade takes place through the preferential route, while around 300 PTAs have been notified to the World Trade Organisation (WTO). This monograph is about PTAs and attempts to address some of the reasons behind their proliferation, impact on the multilateral trading system (MTS) as well as the specifics that PTAs entail, in a simple language, with examples, without offering any opinions.

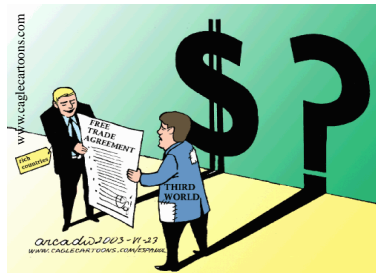
Over the last one-and-a-half decades, CUTS has been bringing out reader-friendly documents on various issues related to globalisation, trade and investments. The purpose is to present comprehensive information in a concise and easy to read format for laypersons. In addition to other publications, a series of monographs, entitled “Globalisation and India – *Myths and Realities*”, is being published since September 2001, with the objective of generating awareness on general economic and trade-related issues. This is the 14th monograph in this series.

This booklet starts with a brief on the different types of PTAs and why countries enter into such an agreement. It goes on to outline the evolution process and point out why PTAs may be inconsistent with General Agreement on Tariffs and Trade (GATT) rules. Rules of origin (RoO) and negative and positive list approaches that form the basis of PTAs are explained in the following sections.

Investment flows and service trade within the realm of PTAs are explained, as these have been increasingly gaining importance in preferential agreements, due to the large benefits that they bring above and beyond trade in goods. While most PTAs are non-reciprocal and discriminatory in nature, hence incompatible with WTO rules, reciprocity is a key element of Economic Partnership Agreements (EPAs). EPAs and other partnership agreements are also explained with examples.

The broad effects of PTAs and their specific consequences on production, efficiency, competition and welfare are discussed. Lastly, the debates and discussions surrounding the age-old question of whether PTAs are building blocks or barriers to the MTS are summarised, by drawing from views of both the proponents and the opponents of PTAs.

This monograph serves to inform and guide the reader on the basics of a PTA, as well as various concerns and issues enveloping such preferential agreements.



What is a PTA? What are the Different Types?

*E*conomic integration describes the joining together of nations to adopt a common trade policy, either for reducing or completely eliminating trade barriers. A *PTA* facilitates economic integration that provides for mutual preferential treatment among member nations (i.e., nations party to the agreement), through lower trade barriers. It is not necessary, however, for preferences to apply to all trade between member nations, the degree of coverage depending on the types of PTAs formed.

Mostly, signatories to a PTA belong to a specific geographical region, for example, the European Union (EU), the North American Free Trade Agreement (NAFTA) and the Association of Southeast Asian Nations (ASEAN). Such PTAs are called Regional Trade Agreements (RTAs). The most common forms of RTAs are Free Trade Agreements (FTAs) and Customs Union (CU).

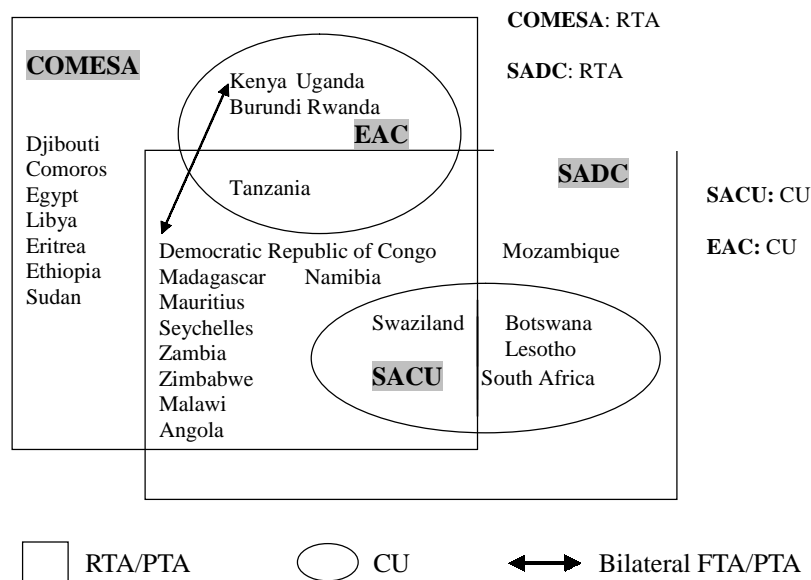
A *FTA* is a PTA through which member nations eliminate trade barriers facing each other, but keep those facing non-member nations intact.

A *CU* can be thought of as a *free trade area* (area covering countries engaged in a FTA) in which members follow the same trade policy towards non-member countries – for instance, the tariff applied on a given product from a non-member country will be the same across all member countries. The most famous example of a CU is the EU.

Figure 1 looks at how the aforementioned regional, preferential and FTAs can overlap with CU. The diagram represents specifically RTAs/PTAs and CUs

from sub-Saharan Africa (SSA). The Southern African Development Community (SADC) and the Common Market for Eastern and Southern Africa (COMESA) have common members, namely, Democratic Republic of Congo, Madagascar, Namibia, Mauritius, Seychelles, Zambia, Zimbabwe, Malawi and Angola. Tanzania is a member of the East African Community (EAC), COMESA and SADC; while Swaziland is a member of the Southern African Customs Union (SACU), COMESA and SADC. Kenya, Uganda, Burundi and Rwanda are members of the EAC and COMESA, while Botswana, Lesotho and South Africa are members of both SADC and SACU. There is a bilateral PTA/FTA between the Democratic Republic of Congo and Kenya – as depicted by the connecting arrow.

FIGURE 1



There are various reasons why countries enter into PTAs:

1. *Security Considerations:* PTAs help enhance the region's external security, through the coordination of member states.
2. *Bargaining Power:* Regardless of whether a PTA imposes a Common External Tariff (CET), its members obtain bargaining power through it,

insofar as the arrangement improves their negotiating positions with third parties. For example, many Latin American countries are said to have entered into PTAs among themselves, in order to improve their negotiating powers with the US.

3. *Enhanced Foreign Investment*: Entering a PTA helps a country attract foreign investment. Investment by member countries becomes cheaper and goods produced through such investment get a ready market in all the countries engaged in the PTA. For example, with the establishment of the EU, it became cheaper for France to import British goods. This made it cheaper and, therefore, more attractive for British players to invest in France. The attraction was strengthened by the fact that the resulting production of goods and services now had a larger market all over the EU, because of the removal of trade barriers facilitated by the PTA¹.
4. *Expanded Trade and Gains from Specialisation*: The reduction of tariffs facilitates trade in products previously not traded. This leads to specialisation and exploitation of economies of scale. A study by Broda and Weinstein, which looked at the gains from import variety, showed that US' gains from trade by importing from new supplying countries amounted to 2.6 percent of its gross domestic product (GDP) in 2001².
5. *Increase in Other PTAs*: Increased participation in PTAs by others prompts a country to join one, lest its markets get captured by countries engaged in PTAs. In addition, this can boost the bargaining position in multilateral trade negotiations, through attainment of greater market power. For example, many agree that the main objective of the Caribbean Community and Common Market – CARICOM – was to “strengthen the region’s external position through the co-ordination of member states’ trade policies”. In fact, CARICOM has, on some occasions, negotiated as a group at the WTO. Similarly, Prime Minister Said Musa of Belize said that the proposed Central American-Caribbean FTA was necessary because, “we need to establish a common strategy so that we can obtain special treatment in international trade negotiations”³.
6. *Involvement in a WTO Dispute*: Although it is recognised that a single GATT/WTO dispute will prompt the involved countries to form PTAs, however, forming a PTA with third parties can give a country hope in improving its leverage in the conflict. For example, it is said that one of Argentina’s key purposes for entering Southern Common Market (MERCOSUR) was to secure preferential access to the Brazilian wheat

market. Brazil was Argentina's leading export destination for wheat and its position in that market was threatened by Canadian and US export subsidy programmes, which Argentina had unsuccessfully challenged in a WTO dispute⁴.

When PTAs were first formed, they generally only covered trade in goods. However, as they have evolved (the evolution process is discussed later), they have come to include trade in services and investment. They have also started to cover trade facilitation issues such as transport and logistics, RoO and other issues like government procurement and intellectual property rights (IPRs).

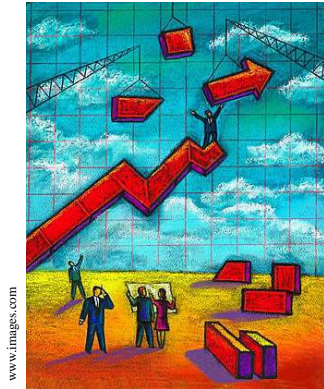


What has led to the Growth of PTAs?

PTA's have grown at a rapid rate over the last two decades. It has been argued that the current slowdown of the MTS *vis-à-vis* the Doha Round has led to an increase in regional economic integration. The underlying argument here is that PTAs give member countries an opportunity to enhance their bargaining powers, which, in turn, can be used to negotiate from a position of strength at the GATT/WTO, thereby enabling the avoidance of disadvantageous multilateral outcomes.

Further, GATT/WTO membership has increased from 22 states, since its inception in 1994, to 153 in July 2008⁵. It is a common view that the increase in the number of member nations gives each member state less leverage. This can particularly apply to smaller countries, which have comparatively modest bargaining power, to begin with, and gives them an incentive to band together to form a PTA to boost their influence.

Moreover, with the establishment of the WTO, which has a formal dispute settlement mechanism, the formal lodging of such disputes has increased. As mentioned in Section 1, the involvement in or loss of a dispute enhances the chances of countries entering into PTAs.



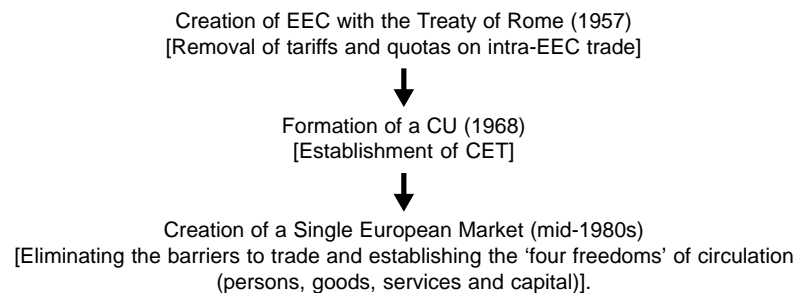
How have PTAs Evolved?

Regional integration/PTA has evolved significantly over time, the evolution being classified in terms of first, second and third waves.

First Wave

The first wave was more geared towards goods trade liberalisation because the tariff rates applied on imports was high at the time. The formation of the European Economic Community (EEC) now the EU, in 1957 marked the first wave. This first wave involved the combination of separate national economies into larger economic areas. It began with a free trade area and moved through consecutive levels of integration (CU and common market) until it reached the point of being an economic union.

The main example of this progression of economic integration is given by the developments in Western Europe after World War II, which is mapped below:



Although it was an economic process, the original intentions behind first generational regional agreements were political. For example, the need for security and war prevention motivated the German and French economies to establish links with each other.

Second Wave: The 'New Regionalism'

The expansion of political influence is the main motive behind the second wave of regional integration, which is commonly referred to as 'new regionalism'. It is based on the notion that trade and economics cannot be separated from the rest of society, i.e., integration has to include poignant non-economic matters such as security, justice and culture, to name a few. There was still emphasis on merchandise trade liberalisation, but this new wave included RoO, non-tariff barriers (NTBs) and other non-traditional areas such as competition policy⁶.

The surfacing of 'new regionalism' needs to be viewed in relation to a series of changes that have taken place over time:

- The new division of power and labour prompted by the shift from a bipolar structure to a multi-polar structure, centring on the NAFTA, the EU and the Asia-Pacific;
- A decline in American hegemony, as a result of the more receptive outlook on regionalism by the US (signing trade agreements with Mexico, Israel and Canada);
- The growth of trans-nationalisation and globalisation; and
- The change in approach towards economic development and political frameworks in post-communist and developing countries.

Box 1: Features of the Second Wave

- Deep economic integration (trade in goods, services, investment, cross-border infrastructure cooperation, etc) with political elements;
- Multi-level governance;
- Devolution within states;
- Strong international legal framework; and
- Cooperation along many dimensions.

Source: Langenhove, L. and Costea, A. (2005)⁷

New regionalism can be seen as an approach taken by countries to react to the multi-faceted impact of the globalisation on their traditional state and market operations. The most advanced form of this type of regional integration is the

EU. However, the second wave is not limited to the European countries. MERCOSUR, ASEAN and Economic Community of West African States (ECOWAS) are other examples of multi-dimensional regional integration. Although, the second wave is as yet limited in its spread, there is evidence of a possibility of integrating the external policy, thereby promoting inter-regionalism. This is known as the third wave.

Third Wave

The third wave of regionalism started in the 1990s, when there was a rapid rise in the number of PTAs. This type of regionalism allows regions to become more proactive with respect to inter-regional agreements and arrangements that can affect the rest of the world, in general. While the EU pioneered this, other regional organisations, such as MERCOSUR and ASEAN, have also followed suit. Currently, there are negotiations between regional trading blocs, such as the EU and ASEAN and the EU and SADC. Thus, PTAs are not only limited between two or three countries but are also extending between two parties, each consisting of several countries. This has made the negotiations for such agreements increasingly intricate.

4



How are PTAs Inconsistent with GATT Rules?

The first clause in the GATT describes the Most Favoured Nation (MFN) principle. It is essentially non-discriminatory (as opposed to preferential agreements) and stipulates that if a country improves benefits for one of its trading partners, it has to “give the same *best* treatment to all other WTO members, so that they all remain *most favoured*”⁸. The MFN has its own exceptions, like most other rules. The first one is that preferential agreements can be formulated (either unilaterally or bilaterally) for the benefit of developing countries. The second exception is that preferential arrangements can be made if these enhance overall welfare. Under certain conditions, FTAs can be justified, using this clause, especially when these benefit the whole world (rather than just the members) through trade creation, which is said to enhance overall welfare.

According to Article XXIV of the GATT, PTAs can be formed if the following conditions are met:

- There should not be an increase in trade barriers towards non-PTA members so that trade diversion is limited.
- All tariffs and other regulations have to be removed within a reasonable time frame on almost all goods in intra-regional trade.
- The agreement has to be registered with the WTO⁹.

GATT’s Article XXIV of the 1947 – GATT’s founding document states that member-states are allowed to form a PTA only if it removes barriers to “substantially all the trade” among its members and does not “on the whole

increase protectionism against non-members”. The ambiguity in these terms allows all nations negotiating PTAs to form trading blocs. In addition, the Enabling Clause (adopted by GATT in 1979) allows developing countries to establish preferences with one another through PTAs, which is in contrast to the rules laid out in Article XXIV.

There have been cases in which trade barriers among nations party to a PTA have not been completely abolished and members often increase trade barriers on products from non-member nations. For example, in line with the EU’s textile and apparel import regime, Turkey increased its quotas against outside states, after signing an FTA with the EU in 1995. In the same way, Mexico, Israel and the members of MERCOSUR increased their external trade barriers after joining PTAs. Even though preferential agreements do not increase external trade barriers, there is some damage to third parties because preferential access for members’ products makes products from non-member countries non-competitive. In this way preferential access itself is a barrier, as it helps member countries capture each other’s markets, at the expense of non-member countries.

There have been efforts to control the formation of PTAs, but these have met with little success. Members are required to notify new preferential arrangements to the WTO which then assesses the degree of compliance of PTAs with GATT rules. However, the WTO has failed to reach a conclusion on almost all of these PTAs, mainly because countries have opposing views as to what comprises compliance. A former GATT Deputy Director General stated, “Of all the GATT articles, this [Article XXIV] is one of the most abused... [New PTA members] have little fear that they will be embarrassed by some GATT body finding them in violation of their international obligations and commitments and recommending that they abandon or alter what they are about to do¹⁰”.



What are Rules of Origin?

RoO are essentially the criteria used to ascertain the country of origin of products, in order to ensure that a member country only provides concessional entry to products of other member countries. Traditionally, these rules have three components – *origin component* (which categorises products according to where they are acquired), *consignment standards* (which ensure that at the port of disembarkation, the products are not subjected to manipulation) and *documentary standards* (adequate documentation needs to be provided as to the origin of the product).

RoO were initially designed to be a neutral device for providing preferential access, gathering economic statistics and finally marking a good. However, the production of goods in different stages in different countries has not allowed a precise definition of RoO, making these rules increasingly intricate. This complex nature of RoO has made their formulation subjective and an outcome of policy, allowing governments to tailor rules to protect domestic firms in a hidden way.

RoO are divided into two categories, namely, *preferential* and *non-preferential* RoO. Preferential RoO are used to establish whether certain products originate in a particular country entitled to receive preferences and, therefore, meet the criteria for the trade preference. On the other hand, non-preferential RoO are used for other functions, such as enforcement of product and country-specific trade constraints such as anti-dumping duties and safeguard measures.

Although the main aim of trade liberalising preferential arrangements is net creation of trade, their use of RoO that are more limiting than non-preferential

rules is actually more geared towards trade and investment diversion. Such restrictive RoO give producers incentives to raise the percentage content of goods that is derived from within the preferential area – through sourcing of raw material, manufacturing, processing and assembly – at the expense of other nations which have a comparative advantage in these. This distortion causes an inefficient allocation of the world's resources¹¹.



What are Negative and Positive List Approaches?

These two approaches facilitate identification of sectors/products for inclusion in agreements and the extent of their coverage.

A negative list approach caters to the liberalisation of all sectors/products (in a phased manner), unless otherwise specified.

A positive list approach is the stipulation of a specific number of sectors/products for preferential treatment, with details about type of access and treatment to be given to each listed sector.

Negotiations associated with a negative list approach are generally preferred to those associated with a positive list approach as the latter entails product by product negotiations and is, therefore, slower progress. A negative list approach enables deeper trade liberalisation as all sectors, except for those banned due to health, environmental, moral and national security reasons are subject to liberalisation. It is generally agreed through associated PTAs to bind the negative (sensitive) list of products so as to ensure that the extent of liberalisation is not compromised.

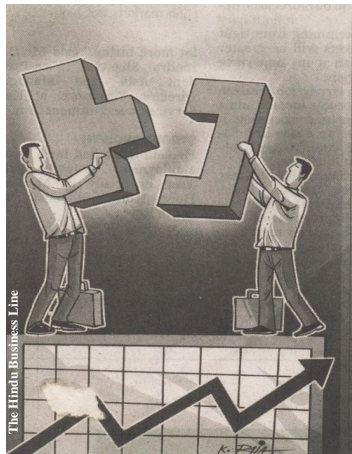
Box 2: Advantages of a Negative List Approach

- The product-by-product negotiations in the positive list approach takes up considerable time and leads to several negotiation rounds, whereas the negative list approach saves negotiating time, especially for countries with a diversified trade structure.
- Under this approach, it is possible to permit other mechanisms for phasing the liberalisation of products, thereby giving more time to the Least Developed Countries (LDCs).
- It allows substantially more trade liberalisation than a positive list approach.
- The role of interest groups in slowing trade liberalisation is reduced because almost all sectors are meant to be liberalised in a phased manner.

Source: Adapted from Mukherji, I N (2005)¹²

There are, however, two pitfalls of a negative list approach¹³:

- One of the biggest concerns with this approach is that governments forgo the right to implement discriminatory measures in the future, even in sectors that do not exist when an agreement comes into force.
- Many countries, especially developing countries, often find constructing a negative list administratively burdensome. As a result, there have been a number of agreements in services trade in the Western Hemisphere concluded without these lists being finalised. For example, provisions for financial services in the NAFTA consist of an incomplete negative list¹⁴.



What are the Effects of PTAs on Investment?

With the emergence of the need for deeper integration in global trade policy, there has been a significant rise in the number of preferential agreements that have included investment in their ambit as a type of non-merchandise trade. Apart from including investment as a subject in existing or future agreements, there has been an increase in the number of regional and bilateral investment treaties. Bilateral Investment Treaties (BITs) and Regional Investment Treaties (RITs) focus exclusively on investment provisions between pairs of countries or between countries of a specific region. The term Preferential Trade and Investment Agreements (PTIAs) can also be used for PTAs that cover investment issues.

Various statistics seem to indicate that PTAs have encouraged foreign direct investment (FDI) flows into member countries. For example, the share of FDI flows in total outflows from the US to MERCOSUR countries increased from 3.9 percent in 1992 to 4.4 percent in 1995, following the enforcement of their PTA¹⁵. Spain and Portugal also experienced investment booms after their accession to the EC in the mid-1980s. It is argued that one of the main motivations behind newly formed PTAs is enhancement of FDI, as these facilitate transfer of new technology, institutional change, heightened competitiveness and a rise in exports¹⁶.

A number of studies have looked at trading agreements and their impact on investment. One study by Blomstrom and Kokko (1997) suggested that MERCOSUR and NAFTA increased inflows of investment, while the US-Canada Free Trade Area had no significant impact on investment¹⁷. Another study by Stone and Jeon (2000) examined the relationship between FDI and trade in Asia-Pacific economies and found that the formation of ASEAN increased intra-bloc trade flows, but there was no major impact on intra-bloc investment¹⁸. Stein and Daude (2001) tested the impact of institutional variables and preferential agreements on FDI flows and found that the impact of PTAs was positive, but statistically insignificant¹⁹.

Some critics say that it is hard to attribute the increase in investment *solely* to PTAs. Often empiricists have struggled to find suitable data or methodologies for the testing of hypotheses. Thus, although most studies have found an increase in inter-regional investment flows after the implementation of PTAs, these have not been able to “isolate the integration effects from other major contemporaneous macroeconomic and institutional changes²⁰”.



What are the Effects of PTAs on Services?

Services are seen as “intangible, invisible and perishable, requiring simultaneous production and consumption²¹. The service sector is the fastest growing sector of the global economy, accounting for two-thirds of the world’s output, a third of global employment and almost 20 percent of the world’s trade. As a result of the rise in trading activity in the service sector, a General Agreement on Trade in Services (GATS) was negotiated in the Uruguay Round. It covers all internationally traded services such as financial, environmental and educational services.

Box 3: Four Modes of Trading Services

- *Cross-border supply* – Known as Mode 1 in WTO jargon, this includes services supplied from one country to another, for example, international telephone calls.
- *Consumption abroad* – Known as Mode 2, this involves consumers making use of a service in another country, for example, tourism.
- *Commercial presence* – Known as Mode 3, this involves foreign firms setting up subsidiaries or branches to provide services in another country, for example, foreign banks establishing operations in a country.
- *Presence of natural persons* – Known as Mode 4, this entails individuals going to another country to supply services, for example, consultants.

Source: WTO²²

Preferential agreements have different approaches to liberalisation of services in terms of scope, sectoral coverage and exclusions and the gradual phasing in of various sectors over time. These agreements often involve deep commitments for ensuring effective market access. With respect to liberalisation modalities, these agreements have negative and positive list approaches and RoO that could exclude third party suppliers.

North-South PTAs are increasingly looking to integrate services into the design of agreements with considerable opening of developing country markets. These agreements favour a negative list approach with regard to investment, movement of business persons and government procurement. North-South PTAs which have provisions pertaining to service trade include EU partnership agreements, such as the African, Caribbean and Pacific (ACP)-EU EPAs currently in negotiation and the South Africa-EU trade and development cooperation agreements. South-South PTAs with provisions relating to service trade are also an important part of the development strategies of developing countries.

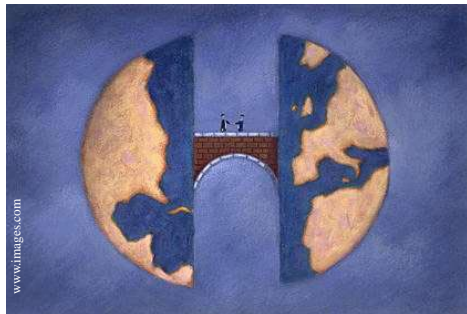
Box 4: Examples of Development Initiatives of South-South PTAs in Service Trade

- In MERCOSUR, they followed a GATS-like approach with a positive list and have made commitments to increase sector coverage in the positive list over various rounds of negotiations with the view of eliminating all restrictions to service trade within ten years of entry into force.
- In CARICOM, they are working towards a single market for services, free capital movement, relatively high degree of labour mobility and deeper commitments than GATS.
- In ASEAN, they have followed a GATS-like approach with a positive list and have committed to liberalise business services, construction, air transport, telecommunications and tourism and maritime transport.
- In SADC, there is a goal of substantial service trade liberalisation by 2015.

Source: Mattoo, A. et al. (2008)²³

As mentioned earlier, PTAs have become wider in scope and coverage, as countries move towards deeper integration. With these developments, the integration of developing countries through PTAs that involve trade in services would give a boost to their economic development. For this to happen, there is a need for careful design and effective implementation of policies and regulatory frameworks, along with “pacing and sequencing of domestic reforms and regional and multilateral liberalisation²⁴”.

9



What are Partnership Agreements?

Countries that have already formed PTAs are increasingly looking to moving towards more integrative trade agreements with each other, with a view to boosting trade relations and performance of the respective economies. The result has been the formation of various partnership agreements. The first example of this type of agreement is the EPA formed between the EU and ACP countries. This was meant to be consistent with the GATT rules of MFN and reciprocity, as the earlier agreement between the European Commission (EC) and the ACP had breached these provisions.

Today, the EU is looking to form EPAs with not just the ACP but also with China, India and countries in Latin America. The EU is looking to negotiate EPAs with developing countries to develop new trade arrangements “that must support the structural economic transformation...” of these countries. However, there has been a lot of criticism regarding the motive behind such an ambition. One of the main criticisms of the EPAs with ACP countries is that these expose small-scale ACP farmers and infant industries to heightened competition from subsidised European agricultural products and industries, thereby creating a disadvantage for ACP countries²⁵.

Box 5: Examples of Other Partnership Agreements

- *Comprehensive Economic Cooperation Agreement (CECA)*: India's first partnership agreement was the CECA (formed in 2005) with Singapore. The agreement aimed to increase trade flows between the two countries, as well as encourage substantial Singaporean investment in India.
- *Comprehensive Economic Partnership Agreement (CEPA)*: The India-Sri Lanka Free Trade Agreement (ISLFTA) was signed in December 1998 and came into operation in March 2000. This agreement has led to a substantial expansion of trade between the two countries. Due to its success, both countries decided to work on a more comprehensive trade partnership agreement in 2003. This CEPA has four goals: "widening and deepening of the existing FTA, establishing an agreement on trade in services, including measures for promotion of investment in each other's countries and enhancing economic cooperation". However, it is proving difficult to negotiate.
- *Trans-Pacific Strategic EPA*: This agreement was signed by New Zealand, Chile and Singapore and later by Brunei in the second-half of 2005, after negotiations concluded in June 2005. Some of the results of this EPA are collaborative business ventures and joint research activities in science and technology.

Sources: *The Hindu* (2005)²⁶; *Abeyasinghe, S. (2005)*²⁷; *New Zealand Ministry of Foreign Affairs and Trade (2008)*²⁸



What are the Consequences of PTAs?

There are both advocates and critics of PTAs. Advocates opine that reducing trade barriers creates competitive pressures and opportunities for transfer of technology, leading to productivity gains. They argue that trade openness also increases the market size, which can attract FDI. Thus, advocates say that a PTA creates more trade with some countries, contributing to development and thus showcasing the benefits of increased openness to both member and non-member countries. Critics of preferential arrangements, however, highlight the degree to which trade increased by PTAs distorts trading patterns involving members and non-members, thereby spurring inefficient specialisation.

The two broad consequences of preferential agreements are:

- *Trade Creation:* This is the favourable effect of a discriminatory trading arrangement and is defined as the addition to the volume of international trade, brought about by a preferential trade arrangement. Consider the case of a country not importing a specific product, but instead, locally producing it in an inefficient manner. However, as a result of the formation of a trading bloc, the product is imported from firms in member countries that produce it efficiently. This results in trade creation and since the product in question was not being imported from a non-member state prior to the formation of the agreement, outsiders do not lose out on exports and are, hence, unaffected. In addition, new product varieties are imported as a result of the PTA, which can lead to a rise in consumer welfare.

- *Trade Diversion:* This is the efficiency-reducing consequence of a trading bloc. It happens when a member state was previously importing a product from an efficiently producing non-member state. As a result of discriminatory tariff cuts provided for by the agreement, another member nation takes export sales away from the non-member. World efficiency is reduced because trade is diverted from low-cost to higher-cost sources²⁹.

The above-mentioned broad effects of PTAs can be seen in the following specific consequences of preferential arrangements:

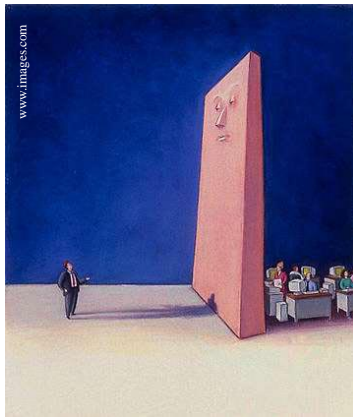
- *Cultivating Competition:* Preferential arrangements enhance competition, through entry of foreign competitors into previously protected sectors of the domestic economy. This foreign entry also forces domestic enterprises to increase their efficiency due to greater competition in the domestic markets. Most economists argue that gains from efficiency generated by PTAs are smaller than those generated from multilateral trade liberalisation. In the worst case scenario, PTAs can generate incentives for non-competitive behaviour by either protecting certain sectors (which would otherwise be exposed to import competition) or distorting the evaluation of return on investment, as producers in member countries are provided privileged access to markets.
- *Inefficient Production:* PTAs can result in distorted specialisation in a country which is not in conformity with the relative efficiency of the sectors. Further, if a country entering a PTA has comparative advantage in low skills manufacturing, it may end up specialising in this sector, rather than moving to the more lucrative and advanced higher technology sectors. RoOs are also important determinants of specialisation patterns, because these can be a source of potential distortion. Moreover, RoO administration can lead to rent-seeking and corruption.
- *Trade Levels:* Trade diversion may offset trade creation and the potential for this diversion increases as the difference between external tariffs and intra-PTA tariffs rises. RoOs also provide incentives for trade diversion (except in CUs), resulting in 'indirect trade deflection'. This involves imports entering the PTA area through the country with the lowest external tariff.
- *Market Size Effects:* Industry level scale effects are varied, leading to the conclusion that "large market" benefits of regional integration depend on the size and structure of member nations. For example, in some studies it was found that industries in ASEAN countries have not benefited from scale effects of regional arrangements.

- *Distribution of Welfare Gains*: The welfare gains from trade creation, resulting from PTAs, are different from those resulting from general liberalisation. Firms belonging to PTA member countries gain a first mover advantage in the protected preferential area, while firms of countries joining the PTA at a later stage are put in a disadvantageous position. For example, a study using EU data showed that the earlier members received larger benefits, in terms of expanded market shares, compared to the new EU members³⁰. A bigger concern is that non-members clearly suffer losses from reduced exports and/or deterioration in their terms of trade. The terms of trade effect varies with the size of the PTA – larger PTAs tend to generally affect the prices of tradable, whereas smaller PTAs affect such prices only if there is market segmentation. For example, excluded Argentine producers had to lower their cattle prices to access the Andean Pact market³¹.

There has been substantial research focusing on the balance between welfare loss from trade diversion and welfare gain from trade creation. Welfare loss can also result from loss of tariff revenue for the government. In general, it has been suggested that PTA liberalisation tends to have a positive effect on welfare consequences for the liberalising a country. However, the general conclusion of theoretical work evaluating the relationship of PTAs to changes in trade flows in purely economic terms is that PTAs are welfare-reducing for the world as a whole.

The debate about whether PTAs have led to a growth in trade around the world is still inconclusive. There have been many empirical studies trying to determine whether specific PTAs (such as NAFTA, MERCOSUR, AFTA, etc.) have resulted in net trade creation or net trade diversion. For example, older studies have found that NAFTA has not had any significant impact on trade flows among its member countries and some have shown that the agreement has diverted trade away from non-member countries³².

New empirical studies suggest that whether and how preferential agreements affect trade flows depends a lot on the provisions of these PTAs, especially with respect to their implementation, coverage (of merchandise trade and/or non-merchandise trade), tariff liberalisation schedule and dispute resolutions. Many argue that this aspect makes it hard to reach a specific conclusion about what effects PTAs, as a whole, have had on the volume of world trade³³. To add to this ambiguity, the synergy between tariff preferences and investment – a major source of benefits from PTAs – remains under-explored.



PTAs: Building Blocks or Barriers?

The proliferation of PTAs *vis-à-vis* regionalism over the last few years has prompted many debates and discussions on whether these types of agreements are building blocks or barriers towards the MTS. The following portion looks at the arguments under each of these two categories.

Building Blocks

- *Regionalism Enables Smooth Handling of Controversial Cases*

The controversial cases pertain to highly restricted activities or highly technical areas (such as industrial standards) where rigorous negotiations are necessary. In these cases, it has been argued that regional liberalisation would be more feasible than global liberalisation. Moreover, once regional blocs are formed, it might provide impetus for future multilateral liberalisation. An example of this phenomenon is mutual recognition of technical standards among EU countries influencing the Uruguay Round negotiations. This is a potentially strong argument for the claim that regional arrangements are the stepping stones to multilateralism.

To illustrate the same argument, a number of bilateral agreements cropped up during the 1930s, when import tariffs were high. These agreements offered

reciprocal preferences and were politically feasible because these ensured export expansion in partner markets (at a time when there were fears that export growth might not accompany import growth). These, in turn, set the stage for multilateral reduction of tariffs. Keeping the above arguments in mind, it is important to ensure that the switch from regionalism to multilateralism is managed efficiently.

- *Regionalism Leads to Multilateral Negotiations*

There is an argument that enhancement of regional trade helps foster multilateral trade negotiations. For example, commentators have argued that the formation of the EEC led to the Dillon and Kennedy Rounds of GATT negotiations, with the US looking to alleviate the EEC's potential to cause trade diversion. There have been similar arguments regarding regionalism, prompting the Tokyo Round and the conclusion of the Uruguay Round. However, these arguments have attracted some criticism.

The main contention is that the formation of such regional blocs tends to have a bigger effect on the incidence than the timing of multilateral negotiations. Others argue that if the above hypothesis was indeed true, EEC members would have negotiated terms that their non-EEC trading partners would consider harmful, so that these could negotiate agreements with the latter to provide concessions for the mitigation of such potentially harmful trade conditions.

- *Multilateral Negotiations Become Simpler with less Participants*

This is so because each trading bloc can come to the multilateral negotiating table to formulate agreements. However, this would only be effective if each such participant has the authority to negotiate effectively. The process can be slowed down because each bloc would have to first negotiate a common position among its members before coming to the multilateral talks.

Barriers

- *Trading Blocs Will Raise Tariffs on Non-member Countries*

It has been argued that this is not a valid generalisation, even though it may occur in some cases. First, members of free trade areas may, in fact, have a good reason to reduce tariffs on non-member countries because that would reduce the extent of welfare-reducing trade diversion. The second argument is that if increased imports from member countries harm domestic firms,

governments may have an incentive to reduce the external tariff so that imports from non-member countries can substitute for these increases and the government can collect revenue on these imports without inflicting further harm on domestic firms³⁴. However, there is no guarantee that such actions would not cause further harm to domestic firms, as these will have to compete with imports from both PTA members and non-members.

Another concern is regarding the formation of a customs union leading to more secure markets and prompting the levy of higher tariffs on products of non-member countries. However, it is argued that this does not necessarily represent a retreat from multilateralism because non-members can respond by reducing their trade barriers and entering into negotiations with the CU. In addition, the WTO's rules for forming a CU (restricting the increase in average tariffs) act as a disincentive for customs unions to raise tariffs facing non-member countries. However, as discussed earlier, WTO rules have not been strongly enforced.

- *Regionalism has a 'Domino' Effect*

This has been widely accepted as being true. A regional preferential agreement reduces the competitiveness of non-members *vis-à-vis* member countries, as the former pay higher tariffs. Another characteristic of PTAs is that these result in lower firm costs for member countries in the event of the incidence of economies of scale. These two aspects of PTAs provide incentives for nations to join PTAs or form other agreements of their own.

An example of this type of 'domino' regionalism is the attempt by Scandinavian countries like Finland, Norway and Sweden to seek accession simultaneously to the EU, for fear of a decline in their export markets. If just one of them had joined, access to the EU market by others would have become less secure. Thus, all three looked for membership at the same time, although Norway ultimately backed out³⁵.

However, countries wishing to join existing trading blocs are constrained by their unwillingness to let new members in, because of the expected disruption to trading patterns. A strategy that non-members can adopt, and have adopted, is to set up rival trading blocs. For example, observers say that EFTA was a response to the creation of EEC and MERCOSUR to NAFTA. Such responses may see the world divided into regional trading blocs. It remains to be seen whether rival trading blocs decide to cooperate or not, with observers agreeing that evenly matched blocs will enhance the chances of cooperation.

- *Regionalism Becomes Costly when Governments have to Address Domestic Lobbies*

Export lobbies prefer PTAs to multilateral liberalisation, due to the preferential access afforded by these. Hence, politically, powerful lobby groups could influence negotiations as well as shape the structure of PTAs. Lobbies may seek inefficient PTAs that result in trade diversion, because their gains come at the expense of non-member countries. Thus, even though PTAs are meant to serve as the stepping stones, they may not benefit some countries due to the influence of strong domestic lobbies³⁶.

- *Regionalism is Generally Risky*

Small countries enter into PTAs with large ones to get access to secure markets and benefit from lower costs associated with economies of scale in production in the larger economy. However, such an agreement provides disincentives for the small country to be a part of the multilateral system and could simultaneously encourage the large country to persist with “access-threatening policies”, emanating from the power to bring others into the trading system³⁷.

Another argument put forward by Bhagwati (2008) is that PTAs between a developed and a developing country are characterised by the developed country pushing the other country to include non-trade issues such as labour and environmental standards in the agreement. This puts the developing country in a disadvantageous position in the multilateral system, because it cannot now oppose the inclusion of such non-trade issues in multilateral trading agreements. The inclusion of these issues, Bhagwati argues, can lead to distorted competition and increased protectionism in favour of developed countries³⁸.

A third argument points to the coercive nature of regionalism bringing countries to the negotiating table. If a country is likely to limit its imports, its trading partners will want to form a PTA that shifts the burden to other nations. This is easier the more non-preferred partners there are, but this leads to countries aiming to secure an arrangement early. Such pre-emptive regionalism is widely argued as being risky.

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